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Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002
Basel
Switzerland

Subject : Application of Own Credit Risk Adjustment to Derivatives

1. EXECUTIVE SUMMARY

1.1 Absa Group thanks the Basel Committee for the opportunity to comment on the consultative document 'Application of own credit risk adjustments to derivatives' issued during December 2011.

1.2 The proposed simplified approach, as interpreted, aims to derecognise the unrealised gains and losses on derivative liabilities from common equity i.e. to deduct it from Common Equity Tier 1 (CET1).

1.3 Highlighted below is Absa Bank's response to the consultative document and the issues raised therein.

2. COMMENTS ON CONSULTATIVE DOCUMENT

2.1 We agree with the principle that an increase in the credit risk of a bank could lead to reduction in the value of its liabilities but that it shouldn't increase its common equity. However, the following issues within the South African context arise:

- In the South African Market, it is not currently market practice to include DVA in derivative instrument valuations for accounting purposes confirmed through various discussions with our external auditors PricewaterhouseCoopers (PWC) and other banks. The main drivers for this being:

- Bank credit spreads in South Africa are typically not observable for non-funded liabilities , especially into the longer maturity ranges, and
    - It is not currently general market practice to price for own credit risk when pricing derivatives.
- For derivative instruments the gains and losses for changes in own credit risk is currently not included for IFRS reporting, and hence not included in retained earning which feed s CET1.
- As a consequence, the proposal is inappropriate as a deduction from the capital base.

2.2 For other jurisdictions where the accounting treatment for derivative instruments takes into account DVA, the following concerns are raised:

- Whilst deducting own credit risk valuations at inception and afterwards is transparent, it is a more conservative approach.

- Regarding the deduction, the paper states that the spread premium over the risk free rate for derivative liabilities should be deducted at each reporting period. More clarity is sought as to the spread and term to be used to determine this adjustment.

2.3 It would seem appropriate to review both the DVA and CVA adjustments under the Fundamental Review of Trading Book for a holistic overview of counterparty credit risk.

We await feedback from the Committee and the National Supervisor on this approach and its adaptability to emerging markets.

Yours Sincerely,

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